May 2023 Market Commentary

In May, U.S. equities demonstrated remarkable stability despite the potentially critical developments at hand. As the government teetered on the edge of the debt ceiling, and with Treasury cash reserves dwindling, it faced its gravest default risk in recent years. This risk was underscored by one-year credit default swaps hitting unprecedented heights, significantly outpacing those observed in 2008 and during prior debt ceiling crises. Interest rates rose in tandem, potentially driven by default risks and the anticipated flood of new debt issuance should a resolution be achieved. Despite these circumstances, by the end of May, no agreement was made. Nevertheless, the equity markets seemed to assign minimal risk to the worst possible outcomes, resulting in a modest +0.4% gain for the S&P for the month.

The debt ceiling standoff, despite increasing outlier risks, also provided attractive spread trading opportunities. Far out-of-the-money put options maintained their value, thanks to the persistent demand for hedging. However, the absence of significant downside market movements kept the ratio put spreads we held from increasing notably in value. Even though the risk-reward proposition of these positions was as enticing as we've seen in recent months, numerous spreads expired worthless. As a result, the Strategic Program's net return was down 0.15% for May.

The Tactical Program profited from the continued value found in credit spread trading, resulting in a net gain of +0.23% for May. The heightened demand for downside risk protection pushed up the prices of put options. Moreover, the negligible sell-off in the domestic equity markets resulted in all our spread trades being profitable for the month. Despite the potential fallout from the debt ceiling, the VIX remained relatively low given the market stability. Still, it was noticeably elevated compared to realized volatility.

Should the debt ceiling standoff be resolved swiftly, the Treasury would be required to issue a substantial volume of new debt to sustain government operations. Similar debt offerings occurred during the 2008 and 2020 crises, but the repercussions this time around may significantly differ, given the relatively stable stock market. This influx of new debt could result in tightened bank lending, subsequently impacting the U.S. economy. We are closely monitoring this unusual situation in the event that the debt ceiling issue is pushed down the road, and we remain vigilant for opportunistic trades amidst ever-changing market conditions.

As always, we deeply appreciate your continued trust and support in Warrington Asset Management.